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ECONOMIC INDICES: MANAGING BY THE NUMBERS

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Understanding indices is not just about crunching numbers, but appreciating how it is constructed

Read through a newspaper and you will likely come across one or more of the following terms: Consumer Price Index (CPI); core inflation; housing index etc. These economic measures are so commonly used, it is often assumed that people understand exactly what they mean in the broader economic context.

“There’s been a lot of controversy about the use of Consumer Price Index to represent the changes in the cost of living,” explains **Kevin Fox**, Professor of Economics & Director of the Centre for Applied Economic Research at the University of New South Wales. “Most people think, ‘It doesn’t represent what’s happening to me.’ That’s because it’s not for any one individual in the economy, it’s the overall measure of the price change in the economy.”

Speaking to *Perspectives@SMU* on the sidelines of the *SKBI Annual Conference on Financial Economics*, Fox elaborated that “various groups feel they’re being disadvantaged because their cost of living is not being adequately represented, such as the elderly...or people on welfare payments who think that price falls in certain goods apply to rich people but not to themselves. Therefore, the indexation of the welfare payments is not going up quickly enough to compensate for the changes in inflation that they are experiencing.”

“The CPI is used primarily in many countries now for inflation targeting, and that purpose isn’t always consistent with its use as a price index for welfare payments. There’s an argument that there should be different indexes for different purposes, and ultimately we would like governments to recognize each of us as a different consumption individual, and explicitly acknowledge our own experience of inflation.”

DATA IS KING

Fox believes that there's a window to educate parts of Asia which are still fairly new to the development of national account statistics. "I think internationally, what's needed is more education in what these indices mean. Asia has an opportunity to learn from other countries and understand that what's being done is perhaps not good enough, and I think there's an opportunity here to raise the level internationally."

As for what should be taught, Fox quoted former President of the American Economic Association, Zvi Griliches, who thought that econometricians had lost their focus on the importance of quality data: "It is the preparation skill of the econometric chef that catches the professional eye, not the quality of the raw materials in the meal, or the effort that went into procuring them."

"Griliches thought that was the way the academic profession was going. That was a few years ago, and I think it's still true now," Fox laments. "We need to understand the data, how it's collected, and understand the difficulties and the methods. (We also need to) understand how sensitive the estimates are to the methods used, and I think that should inform the results and policy conclusions that come out of that, rather than saying, 'The data are the data, let's move on.'"

MANAGING: BY THE NUMBERS

While indices such as the CPI are sometimes misunderstood, they are nonetheless useful to managers running a business. "Any business manager should keep a close eye on core economic statistics such as the inflation rate, because that will give a hint as to what will happen to interest rates," says Fox. "If the central bank is targeting the inflation rate, they'll also keep a close eye on key output measures such as Gross Domestic Product. That might give an idea to business managers how the government might respond to economic conditions, such as whether they might engage in fiscal policy to help and try to stimulate the economy. This has impacts on the business environment."

In a best case scenario, policymakers would have a keen appreciation of economic statistics, and business people would understand what those figures mean to their businesses. But all that is predicated on quality data that are reliable and accurate, which does not come free.

"There needs to be investment in statistical agencies. When governments are under budgetary pressure, they look to make cuts, and...statistical agencies are usually an easy target," says Fox. "What the government is doing by cutting the budget of statistical agencies is basically to deprive themselves of quality information. Investing in the resources and skills and training of people working the statistical agencies is key."